SUPREME COURT, U. S.

No. 959

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# In the Supreme Court of the United States

OCTOBER TERM, 1962

AMOR F. PIERCE and IDA MAE PIERCE, PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

W. LEE McLANE, JR.
NOLA McLANE
THADDEUS ROJEK
27 North Country Club Drive
Phoenix, Arizona

*Counsel for Petitioners*

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# In the Supreme Court of the United States

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No. .....

AMOR F. PIERCE and IDA MAE PIERCE,

*Petitioners,*

v.

COMMISSIONER OF INTERNAL REVENUE

*Respondent.*

## PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on December 28, 1962.

## OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States are reported at 37 T.C. 1039. (R. 36.) The opinion of the Court of Appeals is reported at 311 F. 2d 894. (Appendix, *infra:* R. 143.)

## JURISDICTION

The Judgment of the Court of Appeals was entered on December 28, 1962. (Appendix, *infra*, R. 145.) The jurisdiction of this Court is invoked under 28 U.S.C. 1254.

## QUESTION PRESENTED

Whether the court below could properly *refuse to rule* on the question before it of whether $220,140 of net cash value in annuity contracts with a face value of $600,000 was sufficient to appreciably affect the petitioners' beneficial interests so as to qualify the transaction as an "annuity arrangement with nontax substance" within the meaning of *Knetsch v. United States*, 364 U. S. 361.

## STATUTES INVOLVED

Internal Revenue Code of 1954:

"Section 163. INTEREST

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

Section 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) General Rule.—No deduction shall be allowed for-

* * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

## STATEMENT

The controversy involves the proper determination of petitioners' liability for federal income taxes for the calendar year 1954.

On December 13, 1954, Amor F. Pierce hereinafter referred to as petitioner, applied to the All Service Life Insurance Corporation, Phoenix, Arizona hereinafter referred to as All Service, for six (6) retirement annuity contracts. The consideration specified for each contract was $100,000, payable in six annual installments of $16,666.67 each, or a total consideration for the six contracts of $100,000. As payment of the first annual consideration of $100,000 All Service, on December 13, 1954, accepted petitioner's 6% demand promissory note in the face amount of $100,000. (R. 12, 37, Exs. 1-A, 2-B, 3-C).

All Service, on December 13, 1954, accepted petitioner's application and issued to him six (6) retirement annuity contracts, dated December 1, 1954. Petitioner's daughter, ten years of age at the time, was designated as the annuitant in three of the contracts and petitioner's son, one year of age at the time, was designated as the annuitant in the other three contracts. Each of the contracts provided therein that the maturity dates of the contracts may be accelerated at any time by option of the owner and annuitant. Petitioner is designated as the owner of each of the six contracts. (R. 4, 37, 38; Ex. 4-D).

On December 13, 1954, All Service agreed to and did loan petitioner $117,441 pursuant to the terms of six contract loan agreements executed by him, each in the amount of $19,573.50. As sole collateral security for said loans the petitioner assigned to All Service the six annuity contracts. None of said loans were non-recourse in nature. The contracts provided that all or any part of the loans might be repaid at any time while the contracts were in force and that the interest rate on the loans was a guaranteed rate. (R. 12, 38; Exs. 4-D, 5-E, 7-G).

All Service, pursuant to petitioner's instructions, applied $100,000 of the proceeds of the loan to the payment of the demand promissory note which petitioner had delivered in payment of the first annual consideration and, on December 28, 1954, delivered its check in the amount of $17,441, represent-

ing the balance of the loan proceeds to the Farmers and Stockmens Bank, Phoenix, Arizona for credit to petitioner's account therein. (R. 13, 38; Ex. 7-G).

On December 28, 1954, petitioner paid to All Service the sum of $24,718 as interest on the loan of $117,441 for six (6) years in advance at the rate of 3.75% per annum, with interest paid for more than one year in advance discounted at the rate of 2.75% per annum, compounded annually. (R. 13, 39, Exs. 9-I, 10-J). On their joint federal income tax return for the calendar year 1954 petitioners claimed a deduction in the amount of $24,718 as interest paid to All Service. Said deduction was disallowed by the Commissioner of Internal Revenue. (R. 14, 40; Ex. 1-A).

In each of the following five years (1955 through 1959) additional new loans were made by petitioner with the annuity contracts being assigned as the sole collateral security therefor and $100,000 of the proceeds of said contract loans was applied each year either to the payment of promissory notes which had been tendered in payment of the annual consideration then due or directly to the payment of the annual consideration then due. The remaining balance of the loan proceeds was delivered to the petitioner or his bank for credit to his account therein. In each of the years from 1955 through 1959 petitioner paid interest on the then existing indebtedness for one additional year in advance and on the newly created indebtedness for five or six years in advance. As of the end of the year 1959, the total outstanding indebtedness created by the foregoing-described transaction was $794,702.04. (R. 15-31, 40; Exs. 11-K through 39-MM inclusive, Ex. 43).

In December, 1960, an additional new loan in the amount of $20,202 was made, with the annuity contracts being assigned as the sole collateral security therefor. Consequently, the total outstanding indebtedness secured by the six annuity contracts as of the end of the year 1960 was $754,904.04. As of the same

time, interest on the then outstanding indebtedness had been paid by petitioner through and to December 1, 1965. (R. 32, 33, 41; Exs. 40-NN, 41-OO, 43).

In response to an inquiry, initiated by him, petitioner was advised by All Service that it would be possible for him, upon his election to do so, to convert the annuity contracts into retirement annuities for himself. (R. 133).

On February 29, 1961, All Service received from petitioner a check drawn on the account of Investors Stock Fund payable to the order of petitioner, and properly endorsed to All Service in the amount of $132,596.11. On February 23, 1961, All Service received from petitioner a properly endorsed cashier's check in the amount of $34,360.19. All Service, pursuant to petitioner's instructions, applied these remittances totaling $166,956.30 to the partial repayment of the existing indebtedness secured by the six annuity contracts, thereby reducing said indebtedness to $587,947.74. As a result of this reduction of indebtedness $39,767 of the previously prepaid interest became refundable and was likewise applied to the repayment of the outstanding indebtedness, reducing it still further to $548,180.74. (R. 43).

On March 28, 1961, All Service received from petitioner a properly endorsed cashier's check in the amount of $23,663.77, which remittance was applied to the partial repayment of the then existing indebtedness, reducing it thereby to $524,516.97. As a result of this reduction in indebtedness, $3,955 of the previously prepaid interest became refundable and was applied to the further repayment of the then existing indebtedness, thereby reducing the indebtedness to $520,561.97. (R. 43).

As of the date of trial, July 6, 1961, the outstanding indebtedness secured by the annuity contracts was approximately $520,562 and the net cash value of the six annuity contracts was $220,140.00. (R. 44).

Sometime during the period February 20, 1961 to March 28, 1961 the annual increase in the net cash value of the annuity

contracts began to exceed the annual interest charges on the indebtedness secured by the contracts. (R. 44).

At the trial the profit potential of the annuity contracts was demonstrated and the Tax Court accordingly found as fact:

(a) If the remaining indebtedness secured by the annuity contracts were repaid by the application thereto of a part of the cash surrender value of the six annuity contracts and the remaining net reserve value of $220,060 allowed to accumulate to maturity in accordance with the terms of the contracts, a monthly annuity would be payable to petitioner's son at his age 65 in the amount of $3,176.89 for the remainder of his life with ten years' payments guaranteed and a similarly guaranteed monthly annuity would be payable to petitioner's daughter at her age 65 in the amount of $2,220.23. If the optional retirement benefit of a monthly annuity for ten years certain were exercised at maturity, petitioner's son would receive a monthly annuity of $4,828.45 and petitioner's daughter would receive a monthly annuity of $3,782.43. Under such option, the net profit from the annuity transaction would approximate $780,750.00.

(b) If petitioner makes no further payments in reduction of the indebtedness secured by the annuity contracts, but does pay one year of interest in advance each year hereafter through the year 1975 and thereafter lets the prepaid interest earn itself out through December 1, 1980, the net cumulative earnings of the contracts will exceed their net cumulative cost sometime during the period December 1, 1967 to December 1, 1968, and the net profit from the annuity transaction as of the year 1980 will approximate $134,353.00.

(c) If petitioner makes no further payments in reduction of the indebtedness secured by the annuity contracts, allows the prepaid interest to earn itself out through December 1, 1965, and thereafter makes a payment of one year of interest in advance each year through December 1, 1979, the net cumulative earnings of the contracts will exceed their net cumulative cost

sometime during the period December 1, 1968 to December 1, 1969, and the net profit from the annuity transactions as of the year 1980 will approximate $108,268.00. (R. 44, 45).

Nonetheless, the Tax Court held that the Commissioner's disallowance of petitioners' claimed interest deduction was not in error for the reason that "there was the same lack of substance in petitioners' purported annuity purchases, loans and interest payments as was found in *Knetsch*." (*Knetsch v. United States*, 364 U.S. 361.) (R. 46). The Tax Court's decision was affirmed by the Court of Appeals. (R. 143).[1]

## REASONS FOR GRANTING THE WRIT

In *Knetsch v. United States*, 364 U. S. 361, this Court denied an interest deduction to the purchaser of $4,000,000 of single premium annuities. Why? Because, said the opinion, the disputed annuity transaction was a sham and fiction. Why? Because, the opinion went on, the "*net cash value* had been kept at the relative pittance of $1,000.", and "therefore *Knetch's transaction*" did not appreciably affect his beneficial interest except to reduce his tax . . .

On the other hand, in the instant case, the petitioner purchased only $600,000 of annuity contracts which had a net cash value of $220,140 at the time of trial and appeal. This net cash value of $220,140 still exists. Yet the Court below disallowed the interest deduction paid on the annuity transaction in 1954. How, and on what authority?

It did so by first concluding that the instant case was controlled by *Knetsch v. United States, supra*,[2] and refusing to rule on

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[1] The Court was careful to point out that: "There may well be single premium annuity arrangements with nontax substance which create an 'indebtedness' for the purposes of § 25 (b) of the 1939 Code and § 163 (a) of the 1964 Code. But this one is a sham." (364 U.S. at 366.)

[2] "The Tax Court determined that the instant case is *controlled* by the case of Knetsch v. United States, 364 U.S. 361 (1960). We agree." (311 F. 2d 895. Emphasis supplied.) "*Quaere* as to whether *Knetsch*

the question of whether $220,140 was a sufficient "net cash value" in $600,000 worth of annuities to qualify the transactions, as this Court said, as "annuity arrangements with nontax substance." This refusal to rule was based on the following language:

> "After the decision of the Supreme Court in Knetsch and while the case was pending before the Tax Court, the taxpayer decided to put 'some substance' into the transaction by increasing his payments to All Service. We agree with the Tax Court that 'such payments, obviously made with a view to influencing the outcome of this very case, can hardly impart retroactive vitality to a transaction that lacked substance in 1954'." (P. 896.)

In other words, after this Court in *Knetsch v. United States*, *supra*, told all taxpayers that the "net cash value" in such annuities must be sufficient to "appreciably" affect their beneficial interest and petitioner complied by increasing his "net cash value" in $600,000 of annuities to $220,140, the Court below held that it did not make any difference. Why not?

Because the Court below ruled either (1) that nothing done after the taxable year (1954) could give "retroactive vitality" to a transaction which *it said* lacked substance in 1954, or (2)

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is in fact controlling. In *Knetsch* the annuity loans were non-recourse, here they were not. Knetsch had to live to age 90 to collect an annuity; here the maturity date of any or all of the annuity contracts could be accelerated at any time by the taxpayer. Knetsch's contracts had been terminated and by reason thereof it was seen that he never had more than $1,000 of "net cash value" in the contracts as compared to $4,307,000 of indebtedness as of the date of surrender; here the contracts are still in force and, as of the date of trial, the "net cash value" thereof was $220,140 as compared to $520,562 of indebtedness secured thereby. In *Knetsch* the annual interest on the loan at all times exceeded the accumulation on the annuities; here, beginning in 1961 and prior to trial, the annual interest charges are exceeded by the annual accumulation on the annuities, resulting in an annual net profit. Knetsch's initial outlay was never recouped; here petitioner's initial outlay or cost will be completely recouped by 1967 when the net cumulative earning will exceed the net cumulative cost of the annuities.

that petitioner's motive in 1961 was "bad" when he paid off a sufficient amount in loans to put $220,140 of "net cash value" into $600,000 of annuities. In either event, the Court below was wrong.

If it ruled as it did because of petitioner's motive,[3] then it acted contra to this Court's opinion in both *Knetsch v. United States*, *supra*, and *Gregory v. Helvering*, 293 U. S. 465, 469. In *Knetsch*, *supra*, the opinion stated:

> "We put aside a finding by the District Court that Knetsch's only motive in purchasing these 10 bonds was to attempt to secure an interest deduction. As was said in *Gregory v. Helvering*, 293 U.S. 465,469: 'The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted . . .'"

Thus, if the Court below refused to rule on whether $220,140 of "net cash value" in annuities totaling $600,000 was sufficient to appreciably affect petitioner's beneficial interest because of his motive in putting the $220,140 of net cash value into the annuities,[4] then it has violated *Knetsch*, *supra*, and *Gregory v. Helvering*, *supra*. Certainly a refusal to answer the question of what constitutes a sufficient "net cash value" because of the taxpayer's motive is the same as holding that where taxpayer's motive is to avoid taxes the claimed interest deduction is disallowed.

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[3] There is a strong indication that the Court below ruled as it did because of a motive of which it disapproved. This is shown by the language in the opinion stating, "We agree with the Tax Court that such payments *obviously* made with *a view to influencing* the outcome of this case, can hardly impart retroactive vitality to a transaction that lacked substance in 1954."

[4] It should be noted that the record in the Tax Court is totally devoid of any evidence, much less substantial evidence, to support the statements of the Court below respecting petitioners' reasons for putting the $220,140 of "net cash value" in the annuities. That is why the Court below forced to use the term "obviously."

Furthermore, the comment of the Court below that the "net cash value" was put into the annuities after this Court's decision in *Knetsch, supra,* is equally out of place. In *Kraft Foods Co. v. Commissioner,* C.A. 2, 1956, 232 F. 2d 118, the Court held that where the transaction attacked had been entered into by entities that could not be characterized as sham entities and had engaged in acts which affected their respective legal relations, "the transaction should not be disregarded merely because the transaction was entered into in response to a change in governing tax law." In so holding, the Court noted (at footnote 19) that:

> "There is no doctrine that taxpayers cannot adjust their affairs in response to a change in the tax laws so as to reduce taxes. Indeed, the structure of the tax law deliberately recognizes tax-conscious motivations and seeks both to encourage them (*e.g.*, rapid amortization of defense facilities, §§ 124, 124A, and charitable deduction for gifts of appreciated property) and to discourage them (*e.g.*, surtax on unreasonable accumulation of surpluses, § 102, and provisions in §§ 24 and 45 relating to transactions between related taxpayers) . . ." (P. 128.)

Therefore, regardless of what petitioner's motive was when he placed $220,140 of "net cash value" in the annuities, it is irrelevant.

Conversely, if the Court below refused to rule on the issue of whether $220,140 in "net cash value" appreciably affected petitioner's beneficial interest on the ground that nothing which occurs after the taxable year involved (1954) can be viewed, even though the annuity transaction is a continuing one, then it contravened not only *Knetsch v. United States, supra,* but the well established doctrine of tax law that "for income tax purposes the component steps of a single transaction are not to be treated separately." *Miller v. Commissioner,* C.A. 6, 1939, 103 F. 2d 58, 59; *Prairie Oil & Gas Co. v. Motter,* C.A. 10, 1933, 66 F. 2d 309, 311; *Walter S. Heller v. Commissioner,* 2 T. C.

371, 381, aff'd. 147 F. 2d 376, cert. den. 325 U.S. 868. Stated in another fashion, the rule is that where "the incidence of taxation depends upon the substance of a transaction . . . the transaction must be viewed as a whole." *Commissioner v. Court Holding Company*, 324 U.S. 331, 334. Furthermore, the rule has been interpreted to mean that "the principle that one transaction may not be broken up into various elements to avoid a tax is not a single, but a double edged sword, as it also may not be broken into various elements to create a tax." *Bubl v. Kavanaugh*, C.A. 6, 1941, 118 F. 2d 315, 320.

Nor is the rule limited to corporate reorganizations where it originated, but includes the area of the disputed annuity transactions. Thus, in *Weller v. Commissioner*, C.A. 3, 1959, 270 F. 2d 294, 297, the Court held that the "substance of the *entire* transaction must be viewed." And this Court itself in *Knetsch v. United States*, *supra*, looked at all of the years of the annuity transactions including 1955 and 1956 even though the taxable years involved were 1953 and 1954, and rested its decision denying the interest deduction on the fact that Knetsch's "annual *borrowings kept* the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000." In fact, this Court, in footnote 5, rejected Knetsch's contention that the annuities had non-tax economic substance since in 10 years the net cash value would exceed the interest paid in because of "the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 loan." In short, the majority opinion in *Knetsch* examined the annuity transaction as a whole, and did not refuse to look beyond the taxable years involved, 1953 and 1954.

Consequently, the Court below cannot refuse to apply the

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[5] In the instant case, and in all of the cases like it, both the Government and the Courts have disallowed the claimed interest deduction on the authority of the doctrine that "substance controls over form." Thus it is hardly possible at this stage for the Government to contend otherwise.

rule announced in *Knetsch v. United States*, *supra*,[6] while at the same time claiming that its decision rests upon the *Knetsch* case. Aside from the prohibition set forth in the authorities cited above, it is only necessary to test what the Court below has done by looking at the other side of the coin. Suppose that a taxpayer had purchased $600,000 of annuities on December 15, 1954 and at that time made payments sufficient to reflect a "net cash value" therein in the amount of $220,140 and thereafter, on either January 15, 1955 or in February of 1961, borrowed back all but $1,000 of the net cash value. Could the Court below, under the applicable law requiring that "the transaction be viewed as a whole, rule in favor of the taxpayer on the ground that nothing which occurred after 1954 could "impart" retroactive lack of substance to a transaction which had substance in 1957?[7] The answer is not only a negative one, but it is obvious that the Court below would not even attempt to invoke such a doctrine. Instead, it has refused to apply "the transaction must be viewed as a whole" doctrine here because, if applied here, the taxpayer, rather than the Government, would be the beneficiary. The accuracy of this conclusion is clearly shown by language from Tax Court opinions dealing with the subject annuity transactions.

In *Emmons v. Commissioner*, 31 T.C. 26 (1958), in reviewing one of the instant annuity interest deduction cases, the Tax Court ruled that:

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[6] Interest deductions will be allowed respecting the subject annuity transactions where the net cash value is sufficient to appreciably affect the taxpayer's beneficial interest.

[7] In a similar vein, if, under the facts of this case, the issue raised was whether the taxpayers are entitled to a deduction for the "economic loss" which the Court has held was sustained in 1954, would the Court, in that event, examine all or merely part of the transaction to determine whether the claimed loss had been realized? Or would the Court consider itself bound by the rule that for income tax purposes whether a transaction has the effect of producing a loss may not be determined by viewing only a portion of the transaction? *Higgins v. Smith*, 308 U.S. 473, 475. *United States v. S.S. White Dental Mfg. Co.*, 274 U.S. 398.

"At the time this proceeding was heard, the alleged loan had not be repaid. (p. 28.)

Then it went on to state that:

> We *find* it far more *significant* that the alleged loan has not been repaid. (p. 28. Emphasis supplied.)

However, in the instant case, the Tax Court said:

> The purported loan-repayments made to All Service early in 1961—more than six years after the taxable year here in issue, only a few months after the Supreme Court has declared the Knetsch transaction "a sham," and less than six months before the trial herein—are in *no way* persuasive of the economic reality of the transaction presently under consideration. Such payments, *obviously* made with a view to influencing the outcome of this very case, can hardly impart retroactive vitality to a transaction that was a sham in 1954. If these 1961 payments have any significance for our inquiry, they merely underscore the absence of a comparable investment in the annuity transaction in 1954." (Emphasis supplied.)

In other words, as far as the Court below and the Tax Court are concerned, the taxpayer loses whether the coin comes up head or tails. If the loan has not been repaid at the time of trial, that fact will be deemed significant and support a finding that the transaction is a sham. Conversely, if the taxpayer does repay the loan prior to trial, that fact cannot "impart retroactive vitality to a transaction that was a sham in 1954," and will support a conclusion that such repayment merely proves there was no substance to the transaction in 1954.

Is it possible for the language of the Court below and the Tax Court to spell out more clearly that the taxpayer is "damned if he does not and damned if he does," and that the Government is being accorded a preferred status in the application of the

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The Court is asked to notice that the phrase "was a sham in 1954" assumes the result to the very issue before the Court below, i.e., is $220,140 a sufficient "net cash value" to remove the transaction from the "sham" and "fiction" category?

legal principle that where the incidence of taxation depends upon the substance of a transaction the transaction must be viewed as *a whole?*

In the instant case the petitioner did exactly what this Court held was required if an annuity transaction was not to be treated as a sham and a fiction. Within a few months after *Knetsch v. United States, supra*, was decided, he increased the net cash value to $220,140 out of a total face value of $600,000 in annuities by repaying with large amounts of cash about one-third of the outstanding loans. If this does not make any difference, and will not even be considered by the Court below, except to prove "bad" motive, then what was the point in this Court taking the time to review *Knetsch v. United States, supra*, and telling taxpayers what must be done for such annuity transactions to qualify for interest deductions? Surely it was not to render and *ad hoc* decision against Knetsch. That result could have been reached simply by refusing to grant certiorari. In short, why should petitioner not be entitled to a ruling on whether or not $220,140 in net cash value out of $600,000 in annuities is a sufficient "net cash value" to appreciably affect his beneficial interest, unless the real rule of law being applied in these cases is, just as the Government orally argued in *Knetsch*, that where a taxpayer's motive is to avoid taxes, no interest deduction is allowed?[9] If that is the doctrine which is in fact being applied, then it should be announced so that counsel for taxpayers can intelligently advise taxpayers whether to continue litigating these cases.[10] As it is, the state of the law respecting the doc-

[9] That it is, is clearly shown by the lengths to which the Court below had to go in order to avoid facing the issue of whether the $220,140 is a sufficient "net cash value" to appreciably affect petitioner's interest.

[10] At the present time there are many cases pending before the Appellate Division of the Internal Revenue Service, and the lower courts, on which action has been stayed pending disposition of the instant case with the thought that a rule enunciated therein will expedite the disposition of the said pending cases.

trine of "substance over form" is hopelessly confused insofar as the subject annuity transactions are concerned.[11] Presently the lower courts are paying lip service to the doctrine that motive

[11] For example, the lower court's decision herein that the transaction must be disregarded for tax purposes because the taxpayer's beneficial interests were not appreciably affected since "the investment resulted in a net economic loss to the taxpayer" reflects confusion as to the meaning and application of the "economic reality" doctrine. That confusion, petitioners submit, results from a misreading of not only the *Knetsch* opinion but also the dissenting opinion of Judge Learned Hand in *Gilbert v. Commissioner*, 248 F. 2d 399, 411, relied on by this Court in the *Knetsch* case. It is true that Judge Hand in the *Gilbert* case said:

> "If . . . the taxpayer enters into a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it, for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. *Gregory v. Helvering* . . ."

However, in expounding on the *Gregory* doctrine, Judge Hand added immediately after the above-quoted language the following:

> "When a taxpayer supposes that the transaction, in addition to its effect on his tax, will promote his beneficial interests in the venture, he will of course secure the desired reduction, for it would be absurd to hold that he must deny himself an economic advantage unless he pay the tax based upon the facts that have ceased to exist. Moreover, *he will also be relieved if he supposes that the transaction will, or may, cause him a loss*, although in that event it is true that his only motive will be to avoid the tax . . . The Gregory doctrine covers only those transactions that do not appreciably change the taxpayer's position, *either beneficially or detrimentally*." (Emphasis supplied.)

Thus, under the economic reality doctrine a transaction in which a loss has been deliberately suffered to obtain a tax advantage may not on that account be disregarded. See *I. Lee Stanton*, 34 T.C. 1 (1960), in which it was held that the taxpayer was entitled to the claimed interest deduction despite the finding that aside from the tax consequences the transaction would result in a loss. Consider further, the examples of (1) a gift of appreciated securities to a charitable organization motivated by the fact that the donor is in pocket more after taxes than if he had sold the assets and kept the proceeds, and (2) a sale or pledge of taxable securities and investment of the proceeds in tax-exempt securities where the transaction makes economic sense only because of the tax treatment of the income from the latter.

must be set aside in applying the "substance over form" rule, and then immediately proceed to rule against taxpayers because of their motive.

In addition, as pointed out by Professor Walter J. Blum of the University of Chicago Law School in an article entitled "Knetsch v. United States: A Pronouncement On Tax Avoidance," The Supreme Court Review (1961) at pp. 135 et seq., despite this Court's ruling in the *Knetsch* case, there remains a great deal of uncertainty and confusion on the part of the trial and appellate courts in the application of the "altered beneficial interests" test and, therefore, a need for further guidelines exists. Professor Blum's prophesy that "almost certainly, considerable doubt will arise over what quantum of commercial substance or effect on beneficial interests is required" has come to pass. In the instant case both the trial and the appellate courts were in such doubt as to how much a taxpayer's interests must be altered before an annuity transaction will be held to have "commercial substance" that they each, in turn refused to rule on the question of whether $220,140 of net cash value in $600,000 of annuities is sufficient net cash value to "appreciably" affect the petitioners' beneficial interest. They refused to so rule even though, in the posture in which the case came before them, that was the only issue to be decided. Thus, the instant case points up, in the strongest manner possible, the need for further pronouncements in this area of tax law and, thus, provides the Court with an opportunity for supplying the needed guidelines.

## CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

W. LEE McLANE, JR.
NOLA McLANE
THADDEUS ROJEK
*Counsel for Petitioners*

MARCH 1963

# APPENDIX

## UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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| ARMOR F. PIERCE AND IDA MAE PIERCE, *Petitioners,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.* | No. 17,951 Dec. 28, 1962 |

Petition to Review a Decision of the Tax Court of the United States.

Before: ORR, MERRILL and DUNIWAY, Circuit Judges.

PER CURIAM:

The question presented is whether deductions from gross income claimed on petitioners' federal joint income tax return for the calendar year 1954 for payments made by them to the All Service Life Insurance Corporation of Phoenix, Arizona constituted "interest paid on indebtedness" within the meaning of section 163(a) of the Internal Revenue Code of 1954. The stipulated facts of the case are set out in the Tax Court's opinion. 37 T.C. 1039.

The Tax Court determined that the instant case is controlled by the case of Knetsch v. United States, 364 U.S. 361 (1960). We agree. The transaction involved in the instant case, as in *Knetsch*, lacked economic significance. There was nothing of substance realized by the taxpayer beyond tax deductions. See Kaye v. Commissioner, 287 F.2d 40 (9th Cir. 1961). In both the present case and *Knetsch*, taxpayers purchased from an in-

surance company long-term deferred annuity contracts of large denominations, executed notes secured only by the annuity contracts, promised to pay interest in advance, and promptly borrowed back the increase in the value of the policies resulting from the advance payment of interest.

At the end of the taxable year in question, 1954, the net cash value of the six annuity contracts was $5,520. Taxpayer's out-of-pocket cost of these contracts was $7,277. Without considering the alleged interest deduction of $24,718, the investment resulted in a net economic loss to the taxpayer of $1,757. Taxpayer's net economic loss from 1954 through 1960 was $31,058. His transaction with All Service did not, therefore, "appreciably affect his beneficial interest except to reduce his tax." Knetsch v. United States, *supra* at 366 (quoting from dissenting opinion in Gilbert v. Commissioner, 248 F. 2d 399, 411 (2d Cir. 1957)). Because the underlying transaction lacked commercial substance, an indebtedness within the meaning of section 163(a) was not created.

After the decision of the Supreme Court in *Knetsch* and while the case was pending before the Tax Court, the taxpayer decided to put "some substance" into the transaction by increasing his payments to All Service. We agree with the Tax Court that "such payments, obviously made with a view to influencing the outcome of this very case, can hardly impart retroactive vitality to a transaction" that lacked substance in 1954. 37 T.C. at 1045. Under the agreement, taxpayer had an election whether to put in more money or not. The case would be different and the result might be different if he were obligated to increase his payments in 1961.

Affirmed.

(Endorsed) Per Curiam Opinion Filed Dec. 28, 1962.
Frank H. Schmid, Clerk.

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

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| AMOR F. PIERCE and IDA MAE PIERCE, Petitioners, v. COMMISSIONER OF INTERNAL REVENUE, Respondent. | No. 17,951 JUDGMENT |

Upon Petition to Review a Devision of The Tax Court of the United States,

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is affirmed. Filed and entered, December 28, 1962.

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# In the Supreme Court of the United States

OCTOBER TERM, 1962

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No. 959

AMOR F. PIERCE and IDA MAE PIERCE, PETITIONERS

*v.*

COMMISSIONER OF INTERNAL REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT*

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## BRIEF FOR THE RESPONDENT IN OPPOSITION

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### OPINIONS BELOW

The findings of fact and opinion of the Tax Court of the United States are reported at 37 T.C. 1039 (R. 36-48). The opinion of the United States Court of Appeals for the Ninth Circuit is reported at 311 F. 2d 894 (Pet. 19-20).

### JURISDICTION

The judgment of the court of appeals was entered on December 28, 1962 (Pet. 21). The petition for a

writ of certiorari was filed on March 28, 1963. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

## QUESTION PRESENTED

Where an annuity-purchase transaction was lacking in economic substance, so that interest payments made in connection therewith were non-deductible in the taxable year when made, can the taxpayer by payments made six years later impart retroactive substance to the transaction and thus render the interest payments deductible?

## STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C. 163):

> SEC. 163. INTEREST.
>
> (a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.
>
> * * * *

## STATEMENT

The material facts as found by the Tax Court (R. 36-46) and as stipulated by the parties (R. 11-35) may be summarized as follows:

On December 13, 1954, the taxpayer, Amor F. Pierce,[1] applied to All Service Life Insurance Corporation for six deferred annuity contracts. The total

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[1] Ida Mae Pierce is involved herein merely because she filed a joint income tax return with her husband.

consideration was $600,000, payable in six annual installments of $100,000. All Service accepted taxpayer's non-recourse six percent demand promissory note in the face amount of $100,000 on December 13, 1954, as payment of the first annual consideration, and issued to him six deferred annuity contracts dated December 1, 1954. (R. 37.)

Taxpayer was then able to borrow $117,441 on the annuity contracts because the net loan value was computed as of December 1, 1960, the date to which taxpayer had agreed to pay interest in advance for the "loan." He borrowed the full amount on December 28, 1954, and applied the proceeds first to the payment of the $100,000 non-recourse demand note which taxpayer had delivered in payment of the first annual consideration. (R. 38-39.)

Taxpayer then paid All Service $24,718 as interest on the loan of $117,441 for six years in advance, at the rate of 3.75 percent per annum (with interest paid for more than one year in advance discounted at the rate of 2.75 percent per annum), compounded annually. Taxpayer paid $17,441 of such interest out of the remaining proceeds from the loan of $117,441. (R. 39.)

As of the end of 1954, according to the books and records of All Service, the net cash value (after adjusting for loans, prepaid interest, etc.) of the six annuity contracts was $5,520. Taxpayer's out-of-pocket cost for the six annuity contracts as of the same time was $7,277, the difference between the $124,718 payment made as interest and premium and the $117,441 borrowed from All Service. But for tax

considerations, taxpayer's purported investment in the six annuity contracts resulted in a net economic loss of $1,757 ($5,520 net cash value minus $7,277 net cost) in 1954. (R. 39-40.)

On their joint federal income tax return for the calendar year 1954, taxpayers claimed a deduction in the amount of $24,718 as interest paid to All Service. The Commissioner disallowed this deduction. (R. 40.)

In December of each of the following five years, additional new loans were made with the annuity contracts being assigned as the sole collateral security therefor and $100,000 of the proceeds of such contract loans was applied each year, either to the payment of promissory notes which had been tendered in payment of the annual consideration then due, or directly to the payment of the annual consideration then due. The remaining balance of the loan proceeds was delivered to taxpayer. In December, 1960, the taxpayer borrowed an additional $20,202. In each of the years from 1955 through 1959, taxpayer paid interest on the then existing indebtedness for one additional year in advance and on the newly created indebtedness for five or six years in advance. (R. 40-41.)

The total outstanding indebtedness secured by the six annuity contracts as of the end of 1960 was $754,904.04. The net cash value of the six annuity contracts, including the net refundable interest paid in advance on contract loans, was $30,878 as of the end of 1960. (R. 41.)

Some few weeks prior to February 20, 1961, taxpayer met with the president of All Service, Robert

Dixon Wood, and discussed and reviewed taxpayer's position with respect to the annuity contracts. The present litigation, which had been continued by stipulation pending the decision in *Knetsch* v. *United States*, 364 U.S. 361, was discussed at that time, and taxpayer expressed a desire "to put some substance into the contracts" by making some additional payments. Taxpayer concluded that an additional investment would have a favorable effect on the present litigation. (R. 42.) Within the following six weeks, taxpayer repaid $190,620.07 of the loans, and applied $43,722 of prepaid interest which was refundable by reason of this prepayment to further reduction of the indebtedness. At that time, and until the date of trial of the present case shortly thereafter, the outstanding indebtedness secured by the six annuity contracts was approximately $520,562, and the net cash value of the six annuity contracts, including the net refundable interest paid in advance on contract loans, was approximately $220,140. (R. 43-44.)

Sometime during the period February 20, 1961, to March 28, 1961, for the first time the annual increase in the net cash value of the annuity contracts began to exceed the annual interest charges on the indebtedness secured by the contracts (R. 44).

The Tax Court found that in 1954 taxpayer's purported purchase of the six annuity contracts from All Service, his borrowing of funds from All Service, and the payment and prepayment of interest to All Service on such borrowing had no economic or commercial substance apart from an intended tax benefit (R. 45-46). The Tax Court concluded that the

purported loan repayments to All Service in 1961, shortly after the *Knetsch* decision, did not "impart retroactive vitality to a transaction that was a sham in 1954." (R. 47.)

The court of appeals agreed with the Tax Court that this case is controlled by the *Knetsch* decision, and that the transaction lacked economic significance to the extent it purported to have created an indebtedness in 1954. Accordingly, the findings and opinion of the Tax Court were affirmed *per curiam*. (Pet. 19-20.)

## ARGUMENT

The decision below was clearly correct. There is no conflict of decisions or any other reason for review by this Court.

1. The result in this case is controlled by *Knetsch* v. *United States*, 364 U.S. 361, which involved the same basic facts. In the *Knetsch* case, a high-bracket taxpayer attempted to create large income tax deductions at the expense of a small net cash outlay in connection with the purported purchase of an annuity from an insurance company. In form, the insurance company lent the taxpayer the amount necessary to purchase the annuity on a non-recourse note. By prepaying the interest on the loan, taxpayer increased the cash or loan value of the contract to permit additional borrowing by him. The net effect of the transaction was that the taxpayer drained off substantially all economic value from the contract and sustained a before-taxes economic loss while staking a claim to a large income tax deduction for "interest."

This Court characterized the alleged benefits of the annuity contract in *Knetsch* as a "fiction" and the amounts "ostensibly 'lent' * * * [a] rebate of * * * the so-called 'interest' payments" (364 U.S. at 365-366). Accordingly, the Court ruled that a transaction so utterly lacking in non-tax economic substance could not give rise to an income tax deduction as "interest * * * on indebtedness" within the meaning of the statute. Taxpayer in the instant case makes no real claim that his case differs from *Knetsch* as of the taxable year 1954, which should be dispositive of the petition.[2]

2. The crux of taxpayer's argument is that both courts below improperly refused to rule upon the question whether the increase in net cash value of his annuity contracts resulting from payments which he made in 1961 constituted a sufficient alteration in his beneficial interest to avoid the impact of the *Knetsch* decision in respect to the "interest" deduction which he claims for 1954 (Pet. 2, 7-9). Clearly, however, both courts below did pass upon this novel contention, the court of appeals echoing the observation of the Tax Court that these payments, made with a view to influencing the outcome of this case, could not "im-

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[2] The distinction sought to be made by way of a footnote (Pet. 7-8) is based principally upon what took place more than six years later. Taxpayer makes the unsupported statement that the loans here were with recourse, as contrasted with those in *Knetsch*. However, the terms of the note and loan agreement (Exhibits 3-C and 5-E in the Tax Court) are such that it is apparent that taxpayer could never have been held personally liable on them.

part retroactive vitality" to a transaction lacking substance in 1954 (Pet. 20).[3]

The basic infirmity in taxpayer's argument is that, under the annual accounting principle, each taxable year is treated as a separate unit, and it is necessary that each item of income or expense be reflected in terms of its posture at the end of the year. *United States* v. *Consolidated Edison Co.*, 366 U.S. 380, 384. In the *Knetsch* case, which involved the taxable years 1953-1954, the Court mentioned the taxpayer's activities in 1955-1956 "to complete the story of the transaction" (364 U.S. at 364), but when this Court turned to an evaluation of what was done in terms of economic substance, its examination was expressly confined to the taxable years involved (364 U.S. at 365-366). Even if this Court there intended to modify the fundamental rule that tax liabilities are determined on the basis of facts known or knowable at the close of the year—as it clearly did not—this taxpayer would not be aided, inasmuch as his transaction with the insurance company lacked substance not only in 1954 but also in the six succeeding years (Pet. 20).

Although taxpayer speculates that perhaps his actions more than six years later were disregarded by the courts below because he had a "bad" motive (Pet. 9), the question of his motive is made relevant only by his attenuated argument (Pet. 10-11) based on the

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[3] Taxpayer unaccountably contends that the record is devoid of evidence to support this statement as to his reasons for the 1961 payments (Pet. 9, n. 4). The finding is supported, however, by the testimony of his own witness (R. 128-130).

axiom that it is the net effect of a planned, integrated transaction which is determinative for income tax purposes, and that the component parts or steps have no independent tax significance. See, *e.g.*, *Commissioner* v. *Court Holding Co.*, 324 U.S. 331. If, by any stretch of the imagination, an "interest" payment in 1954 could be considered part of a single, planned transaction including repayment of loans in 1961, the fact that the latter was not planned from the outset, but resulted only from the intervening *Knetsch* decision, would preclude taxpayer's argument. With respect to taxpayer's assertion (Pet. 10) that he may lawfully adjust his affairs in the light of a change in law, the point may be conceded. The obstacle confronting taxpayer is that such adjustments may not be given retroactive effect.

3. Taxpayer maintains that the state of the law is "hopelessly confused" in respect to the "subject annuity transactions" and that this Court's decision in the *Knetsch* case must be implemented by "needed guide-lines" (Pet. 15-16). Contrary to his assertion, the question whether such tax-reduction transactions can be successfully employed presented no real problem either before or after the *Knetsch* case. As this Court noted in its opinion (364 U.S. at 366, n. 4), all of the prior decisions had been against taxpayers except in the Fifth Circuit, and the *Knetsch* rule has been applied without difficulty in numerous subsequent cases.[4] The whole theory of this type of trans-

[4] *United States* v. *Roderick*, 290 F. 2d 823 (C.A. 5); *Lovett* v. *Commissioner*, 37 T.C. 317, pending on appeal (C.A. 5); *Helwig* v. *Commissioner*, 37 T.C. 1046; *Gerstell* v. *Commis-*

action precludes any substantial non-tax economic benefit from remaining in the annuity transaction, and consequently the courts have not found any up to this point. Future cases will be decided, as this one was, on the basis of what happened as of the taxable year involved and not on the basis of what happened more than six years later.[5]

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*sioner*, decided July 30, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,181), pending on appeal (C.A. 3); *Carpenter* v. *Commissioner*, decided July 25, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,176), pending on appeal (C.A. 3); *Anderson* v. *Commissioner*, decided June 25, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,152); *Salley* v. *Commissioner*, decided April 10, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,080), pending on appeal (C.A. 5); *Estate of Polacek* v. *Commissioner*, decided March 7, 1962 (1962 P-H T.C. Memorandum Decisions, par. 62,048), appeal dismissed (C.A. 9); *Estate of Bennett* v. *Commissioner*, decided November 29, 1960 (1960 P-H T.C. Memorandum Decisions, par. 60,253); *Unilectric, Inc.* v. *United States* (E. D. Wisc.), decided April 28, 1961 (7 A.F.T.R. 2d 1319).

[5] Taxpayer represents (Pet. 11, n. 10) that there are many cases which have been stayed pending disposition of this case. No cases have been cited by him, however, and we are not aware of any.

## CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted,

ARCHIBALD COX,
*Solicitor General.*

LOUIS F. OBERDORFER,
*Assistant Attorney General.*

GILBERT E. ANDREWS,
MARTIN B. COWAN,
*Attorneys.*

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